



THE FEDERAL RESERVE SYSTEM AND THE FARMER

Address of

Chester C. Davis, Member,
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Perhaps it would seem more natural for me, in this setting, to talk to you as I did a year ago in Chicago, about the principles of direct agricultural policy. I confess it is much easier for me to think in the old terms than it is to deal with the words and ideas of the new field to which I transferred last June. My old friends, with whom for years I have had the privilege of working, have helped keep me in the old grooves. Nine out of ten want to talk about the problems of balanced production and marketing, of soil conservation - in short, about the A.A.A. - instead of the problems of credit and monetary control and management.

I now realize that when I left the A.A.A., I felt I was sailing from a storm-tossed sea into a comparatively smooth and protected harbor. Now that I have had a chance at least to survey the new scene, I am not so sure. Some day, when the new landscape becomes more familiar, I may wonder why I didn't conclude, in the words of Hamlet, rather to "bear those ills we have, than fly to others that we know not of".

Occasionally I meet a friend who asks, "What are you doing now?" I tell him I am connected with the Federal Reserve System. Usually he responds with a blank look, and that part of the conversation ends lamely with his asking, "Well, how do you like being a banker?"

It isn't strange that the Federal Reserve System is a thing of mystery. We live in a complex world. We haven't much time to spend in study of a subject not plainly seen as a part of our daily life and

interest. And while a thing remains a mystery, it is easy for it to become an object of some suspicion - especially when a persuasive voice tells us we ought to be suspicious.

That suggests one of the reasons why it is, for me, a real privilege to be here tonight. It gives me the opportunity to tell leaders of agricultural thought something about the Federal Reserve - perhaps to dissolve some of the mysteries. The other and more important reason is this - farmers have been thinking seriously and constructively about how money and credit may be managed to achieve a greater degree of stability in economic progress. They have expressed their conclusions and recommendations through the voice of organized agriculture.

It is not idle flattery when I express my personal belief that organized agriculture has shown a breadth of vision and awareness of the complexity and difficulty of our national problems not matched in other general groups. It has helped educate the country as to the close interdependence of all segments. It has shown concern for the general welfare as well as for its own. It has expressed its attitude through leadership that has in the main been alert and open-minded. I express my conviction, without over-statement, that the salvation of this country as we know it, of its democratic institutions, of the traditions we cherish and wish to preserve, depends on that kind of leadership.

Tonight I want to tell you something of the Federal Reserve System and its organization; to state the broad objective which I conceive to be the concern and responsibility of this agency, along with others

inside and outside the government; to sketch some of the problems that need to be solved as we move toward that objective; and to survey the means and the authorities the law has provided to help cope with those problems.

In this I am speaking for myself alone and not for my associates. Nevertheless, I am sure that they all share my view that the Reserve System needs today as never before to make clear to the leaders of agriculture, business and banking what it seeks to do, why it seeks to do it, what authorities it has and what it has not. Conversely, it needs to know the thought of leaders of agriculture and of other groups. It needs their help and cooperation, their wisdom and their guidance. In no other way can it serve successfully as an instrument of the public interest and of the public will.

The original Federal Reserve Act was approved on December 23, 1913. Its frequent amendments since that date evidence an evolution to meet changing conditions and broadening responsibilities.

The control authority is the Board of Governors, whose members, under the law, must be selected "with due regard to a fair representation of the financial, agricultural, industrial, and commercial interests and geographical divisions of the country."

Let me digress to clear up one common misunderstanding. The present law does not require that one member shall be named who represents agriculture as such. It contemplates that the entire board and all its members shall be representative of all the interests that make up our nation.

I do not regard these interests as fundamentally conflicting. Rather, if interests seem to conflict, it is because some groups fail to understand clearly the economic interdependence of all groups - fail to understand that no one group can permanently prosper at the expense of another group or class.

The Board of Governors is composed of men who without exception regard themselves as representatives not of any one group of class interest, but of the common interest and the public welfare. I am happy to say that without exception these men are extraordinarily interested in agriculture, aware of its importance, and alive to its peculiar problems. Fortunately it is not necessary for agriculture, in its current relations with the Reserve System, to lean upon the weak reed of a solitary and isolated spokesman.

The authorities of the System which relate to management of domestic credit and money are vested principally in this Board. It is therefore a public agency, responsible to the people for an administration that is in the general welfare, and not primarily for the banking or any other single interest.

Its contact with the banking and business structure is through 12 Reserve banks and their 25 branches. Earnings of the Reserve banks, beyond the 6 percent dividend which is paid from earnings to the member banks on stock held, are not subject to distribution among member banks, but must, in case of liquidation, be paid into the Treasury of the United States. Under the franchise tax in effect up to 1933, the Reserve banks

paid \$150,000,000 into the Treasury. One half of the surplus held by the Federal Reserve Banks in 1933, or 139 million dollars, was appropriated by Congress and subscribed as capital stock of the Federal Deposit Insurance Corporation. I mention these items in passing for the sake of those of you who may have regarded the Reserve System as intended and operated for banking profits.

Part of the responsibilities of the Reserve System lies in the direction of control and supervision of banking practices, shared among various - I almost said too many - federal and state authorities. This is not the occasion to discuss that field. Part lies in the field of domestic monetary and credit control, to which I have already referred.

Before I attempt to define what I conceive to be our objective in the second field, in which our interest tonight really falls, let us pause for a moment to consider the conditions which have led thoughtful citizens to insist that currency and credit management must replace laissez-faire and the automatic gold standard.

The Reserve System, as you all know, was created in a pre-war world when it was commonly believed that the gold standard was an automatic regulator and the best device known to man for bringing about a degree of stability in world affairs. I am not competent to say how efficiently it functioned before the World War undermined it. But the fact is that we find ourselves in a world entirely off the gold standard. The prospects of a restoration of that standard in anything like its pre-war form are too remote to help us in meeting the realities of the world.

situation and our domestic problems today.

Every nation, prompted by exhaustion of its gold reserves, or by economic necessity, or by its own foresight, has abandoned that standard. I can understand why many men who have lived most of their adult lives in a gold standard world now yearn for a restoration of conditions and methods which prevailed in a by-gone day, and why many of our banking and business leaders, schooled in a gold standard world, are slow to reconcile themselves to a world in which so many old guides and methods have disappeared. But it is evident that we must be ready to test out and to perfect new instrumentalities and new techniques, in substitution for those which no longer exist, in the common effort to preserve and expand the recovery now so rapidly under way in this country.

The depression from which we are emerging paints the condition which I want you to see as the background for my discussion. It wasn't the first post-war depression as far as this generation of farmers is concerned. They know what deflation means for they have lived through the devastation of two such cycles - that of the early twenties, and the other at the crest of what we were told was a new era of ever-expanding prosperity for the entire world.

Today we hear much talk about the dangers of inflation, but the farmer still remembers vividly the disasters of deflation. Deflation strikes the farmer with particular violence. He is in no such position as is the industrialist to curtail his production. The farmer is obliged to incur debt today at a given price level knowing that it will

be a long time before he can market his crops and derive his income to meet his debts. If during that long interval there is a drastic downward spiral of the price level, in other words, a deflationary spiral, bankruptcy, loss of his farm, of his home, of his livelihood, stare him in the face. We know all about that from painful experience. I recall it only to stress the point that the farmer is particularly interested in avoiding deflation. And I think it has been drummed into us by now that neither the farmer, nor the worker, nor the great mass of our people profit from inflation at the other extreme. In other words, stability, and by that I do not mean a static condition but a stabilized progress, is of vital importance to agriculture.

It has seemed to me, as no doubt it has to you, that broadly we were confronted with two alternatives during the depression that followed 1929: either to let depression take its course until we reached some new bottom on which recovery could be based - in other words, to write down our existing debts by process of bankruptcy, receivership and liquidation until they were at a level at which they could be met - or else to bring up the price level to a point approximating what it was when the burden of debt was contracted, and to restore national income as rapidly as possible to a level at which the debts could then be paid off without wholesale write-downs, bankruptcies, foreclosures, liquidations and all the other violent disturbances characteristic of extreme deflation.

It appears now to be rather generally accepted that the former

course was not the sound or the wise one; that there appeared to be no bottom to the deflation and that to permit that deflation to continue further would be to run the risk of widespread public revolt. It seems to be now more generally accepted that intervention by the government on a scale adequate to stop the deflationary processes and to turn the tide upward was imperative from every standpoint, humanitarian and economic. It was most particularly necessary to restore the agricultural price level because agriculture, as I have said, is likewise the greatest sufferer from violent deflation, as you all well know.

The steps taken with reference to devaluation of the dollar and the program of the Agricultural Adjustment Administration were directed primarily to restoring a more equitable balance for agriculture in our economic scheme. That was the purpose and the result has been in that direction.

I am mentioning this, all too briefly, to suggest one or two more questions in relation to our major problem of greater economic stability. Is it not possible that we can so shape our future course and so direct our policy that the government will serve in effect to counterbalance the cycles which private enterprise, left to itself, has inevitably generated in the past and undoubtedly will continue to generate in the future unless we devise better methods of managing our broad economic problems? Is it not possible to have the government prepared to check speculative inflation and to intervene as an offset if deflation threatens in the future?

When business was local and commerce small in volume, the cycles spent themselves before too much momentum gathered on the swing toward the top or to the bottom. Now that agriculture, finance, commerce, and industry are closely interwoven and in delicate balance, these cycles somehow assume different proportions to me.

There comes to my mind Victor Hugo's vivid story of the battle between men and the cannon that had broken loose in the ship hold during a storm at sea. With each lurch and sway the cannon gathered more destructive momentum until it threatened to batter the ship to pieces. Men captured and chained it.

The very statement of these background conditions suggests the point I am striving to reach - a definition of the objective which is in my mind, and I am satisfied, in yours. Our experience challenges us not only to achieve a greater degree of stability in our economic progress than we have had in the past, but to make that degree a substantial one.

What we all seek broadly is to have our individualistic, profit economy - that sounds like a very ponderous term - to have our economy so function as to call forth the greatest possible use of our productive facilities and man power and the widest distribution of the fruits of our labors, consistent with orderly uninterrupted progress toward higher standards of living for all of our people.

Let me try to express more concretely and narrowly what I believe farmers want - a fair and reasonably constant price relationship between what they have to sell and what they have to buy. They want this

parity of exchange established on a level that will not make debts previously contracted, too burdensome. Then they would like to see this relationship maintained without undue distortion either up or down. Needless to say, they want a steadily expanding market for their production.

That is quite an order. I do not know of any single act of government, any one formula, or any magic or legerdemain, that can accomplish it. I am sure that if I did, I could make a much more inspiring talk here tonight.

The Federal Reserve System is entrusted with certain responsibilities - a certain limited segment of the government's economic battle front. In order to drive home once more the vast complexity of that battle line, let me paint additional details on the background canvas of recent history.

The war had left us with a productive plant overexpanded and distorted in many lines. The second post-war depression was preceded by excessive emphasis on exports, a bad tariff, a huge volume of foreign lendings, an excessively rapid expansion of credit, a faulty distribution of income, and an orgy of speculation in real estate and in securities. Values rose to unwarranted levels - and the consequent collapse was on an unprecedented scale. Once started, the deflation proceeded in a vicious spiral, resulting in a terrific drop in prices, in incomes, in employment, and in the volume of money. Contraction of bank credit and bank money was both the result of the business collapse and the cause of some of its worst phases. Our national income dropped from

80 billions a year in 1929 to less than 40 billions in 1932.

At this juncture the new Administration came into power and adopted a policy of adequate help to the sufferers from the depression, of relief for debtors, of protection to creditors, and of great public expenditures to fill the gap created by the decline in private enterprise. By financing the deficit through sale of securities to banks, the Government restored our supply of money.

How much of this falls in the field of money and credit? It is apparent that in an economy which functions through the medium of money, an adequate supply of money, including bank credit, must be available to do the country's business. Bear in mind that 90 percent of our payments are in fact made by check.

Certainly our present problem is not to create more money. The supply has been restored to a level sufficient to finance a much larger volume of activity than we have yet achieved. With the unprecedented volume of excess reserves of the banking system, resulting primarily from the great tide of gold that has come to our shores, there is far more than enough, both of currency and of bank credit, existing and potential, to finance our farms and factories at a rate of productivity exceeding anything we have ever known.

Our problem now is to consolidate our recovery, to preserve it and to use existing, and if necessary, new instruments to bring about more stabilized progress and greater productivity. By this I mean greater use of our man power in production, increased at as rapid a rate as can

be absorbed by a wider distribution of the fruits of our labor. We must seek, on the one hand, to secure a full recovery and, on the other, to prevent the great supply of money from being syphoned off into speculation in the stock market, in real estate, in commodities or in such other ways as would produce an unhealthy boom, an inflationary condition that would be inexorably followed by another collapse of the fruits of our labors.

The Federal Reserve System is following an easy money policy. As long as we have a great supply of idle men and idle plants, it ought to continue to do so. I have suggested one problem. If the present volume of deposits, with the bank credit that could be sustained on the existing volume of banking reserves, swings into speculative investment instead of into financing production and distribution, we are in for trouble.

To invest our money and credit again for speculative purposes in securities and real estate and commodities would be to tread the path of folly to probable disaster. But under present conditions I certainly am not in favor of the historic method of attempting to check speculative inflation by raising interest rates and tightening the money market all along the line. Until we reach a much larger national income than we have yet achieved, an abundance of cheap money to finance production and distribution is required.

This problem is ours, and it is yours. The farmers are the shock troops in the fight of our economy with the business cycle. They are,

therefore, more immediately and more acutely concerned in the maintenance of an orderly progress, without violent fluctuations, in our economic life.

As I have attempted to indicate, the Federal Reserve System is one instrument which can be used to help achieve that orderly progress. Functioning alone it cannot prevent inflation and deflation, but it should be possible so to coordinate its powers with those of other agencies as to attain a reasonable degree of stability. It should be possible through a better coordination of monetary, credit and fiscal policies to achieve that goal.

So far as the Reserve System is concerned, it has broadly four major powers to influence the volume and cost of money.

First, it can fix discount rates, the rates that member banks have to pay when they borrow from the reserve banks. That is the classical instrument of central bank control, but it is not operative now when banks have more funds than they know what to do with, and consequently do not borrow at any rate.

Secondly, the System can sterilize or make inactive a portion of the existing excess reserves by an increase in the percentage of deposits which a member bank must carry with the Federal reserve bank in its district. You will recall that last July the Board of Governors announced an increase in these reserve requirements.

Thirdly, the System has the authority to purchase and to sell government securities, bankers acceptances, and certain other paper. This is

known as an "open market" operation because such purchases or sales must be made in the market openly and not by direct arrangement with the other parties to the transaction, whether it be the Treasury or private investors and institutions. This function is performed through the mechanism of an Open Market Committee, consisting of the members of the Board of Governors and, by rotation, five presidents of the regional Federal reserve banks. Let me say again that the Board of Governors is a public body whose duty is to exercise its functions in the national interest and not in the interest of any group or section, and that the Open Market Committee, of which the Board of Governors is a majority, likewise functions in the national interest and not in behalf of any private, sectional or group interest.

When the Open Market Committee buys government securities, the effect is to create additional reserves in the banking system as a whole and, therefore, to ease money conditions and to tend to make interest rates low. Conversely, when the System sells securities, the effect, assuming that operations are on a sufficiently large scale, is to tighten money conditions and raise interest rates.

Fourthly, the Board of Governors, under the Securities Exchange Act, is charged with responsibility for fixing margin requirements, which at present are 55 percent. That is to say, those who purchase registered securities must put up 55 percent of the purchase price and bankers and brokers are not permitted to loan more than 45 percent. This instrument which did not exist in 1929, may be expected to impose some curb upon stock market speculation.

In addition, the Board has certain direct powers, to which some authorities attach a great deal of importance, to influence lending policies of member banks and to discourage and prevent speculative use of bank funds.

I am hardly qualified from my relatively brief service to pronounce judgment upon the effectiveness of these various powers, but I do wish to suggest to you several considerations. First, it is evident that these powers are not of themselves sufficient either to guarantee stability, to prevent booms and depressions or to bring about a stable price level. These powers all can be utilized with these objectives in mind, but unless these powers are part of a broader policy pursued by the Government, the Reserve System alone cannot possibly attain the desired objectives. It is important, therefore, to use other instrumentalities. I mention as an example the recently imposed tax on undivided profits. It is evident that this tax has a very direct monetary effect in so far as it tends to prevent the accumulation of large pools of idle funds which in the past have tended to spill over into speculative channels, and in so far as it diverts these funds to where they are not only subjected to a fair share of taxation but are diverted, in part at least, into the general spending stream.

I would like to submit to you the proposition that our goal of more stabilized economic progress can be approached best by concentrating our thought on the maintenance of a high and growing national income. The question is how to insure that this income is more steadily

maintained and directed into productive channels, and away from speculation which generates distortions in our economic mechanism and thus leads to deflation and collapse.

As I see the function of the Federal Reserve System in its relation to the broad general welfare, it is to use its powers so as to contribute to the existence of an adequate supply of money at reasonable rates and to do whatever it can to facilitate the flow of money into the right channels. The flow must not be so fast that it produces an inflation or so slow as to tend in the direction of deflation. It is worth while to recall that we had an adequate volume of money in 1929 and, incidentally, that we were on a gold standard and that we had a balanced budget. Yet these things - very desirable, according to some - did not prevent the depression from developing and then intensifying into the worst crash in our history. It is worth while to remember that the mere existence of a large volume and supply of money was not sufficient of itself either to prevent a deflation or to assure stabilization of the price level. I wish the problem were that simple.

We should put our minds upon the problem of the flow of money, its proper distribution between consumers and investors, so that there may be enough plants to supply our growing needs and enough income in the hands of consumers to buy the products of our soil and our factories.

It seems to me broadly that the effect of the government's policy has been along two lines - first, to create easy money conditions as a result of which debt-carrying burdens could be lightened upon farmers,

and homes, businesses and virtually all other borrowers. Thus it is possible to bring about a large degree of necessary debt adjustment without the violence of bankruptcy procedure. It is possible for states and cities and municipalities to refinance and to obtain funds with which to carry on their contributions to economic and general well-being in their communities through the maintenance of schools, roads, and other customary activities which in many instances had to be curtailed or suspended altogether in the depths of the depression. The Federal Reserve System contributed its share to the creation of easy money conditions and is still pursuing that policy.

Secondly, the government unbalanced its budget in order to raise funds and to put them in the hands of people who would spend them and thus start an upward cycle of business activity. One by-product apart from business activity of itself was to restore solvency in innumerable local communities and states and cities and municipalities which were once more able to collect back taxes as well as current taxes, and to get back on their feet where they would no longer have to lean upon the Federal Government and put a further drain upon the government's resources.

While the total expenditure by the government has been large considered by itself, it is small when considered in relation to the results. I am not undertaking to say that this alone was responsible for recovery. I think I am quite aware of the resourcefulness and initiative of the American people and particularly of our farmers who face

and overcome adversity with genuine fortitude and courage. But the government program gave something for resourcefulness and initiative to work on. After the government had unbalanced its budget to a gross total of some 13 billion dollars during the past three years up to the end of the last fiscal year, there occurred a recovery in the national income which is now running at the rate of well in excess of 60 billion dollars annually, and that at the same time there has been an enormous increase running into hundreds of billions of dollars in the value of farms, homes, stocks, bonds and all the rest of our national assets.

I do not see any reason for believing that we lack as a people the intelligence, through unselfish thinking, to achieve the objective which we all want. The objective is clear. What we want is a steadily rising national income, equitably distributed among all classes. As I have said before, I have no panaceas. I know of no single device, through the gold standard in its old form or in some newly devised form, or through any other simple mechanism, to achieve this objective.

There is undoubtedly much that can be accomplished through enlightened leadership in industry and agriculture and in the field of labor. The objectives of the Federal Reserve System are identical with your own objectives. Such powers as the System has to influence the supply, the cost and the flow of money, it is undertaking to exercise toward the objective of a more orderly, a more stabilized economic progress.

I have learned enough to suspect that monetary management is not an exact science; that there are many incalculable, unpredictable and

unmanageable factors in human behavior and psychology which no set of rules or laws or policies can govern. Nevertheless, I am confident that with the whole-hearted cooperation which I have been privileged to enjoy from leaders of agriculture in all parts of the country, I can as an individual become better informed and better equipped in the discharge of my own responsibilities as a member of the Board of Governors of the Federal Reserve System. And I am equally confident that with cooperation in the study of our common problems and in the seeking of intelligent solutions, we as a nation can find the ways and means of achieving that greater productivity and wider diffusion of real wealth and that greater stability in economic progress which is essential for a progressive nation and for the preservation of our institutions under what we like to call the American System.

I said I had no panacea to offer. I do have a formula to suggest. We live in a swiftly changing world. Governments will play an increasingly important role in assisting their citizens to make adjustments. This will be true of money and credit, as well as of other economic and social factors. In determining what government can do, the all-important thing is the attitude of those to whom you delegate its powers. If they sit tight and inflexible, eyes glued to the past, while the vast energies of this country ensnarl, another and more serious explosion may occur. If they combine intelligent understanding with courage - the willingness to act; if they use, change, discard, or supplement existing means as changing conditions or experience indicate; then government may

assist its people to direct the nation's boundless energy up the road of orderly progress toward a more abundant life for them. I realize that you have heard that phrase ridiculed, but I am glad to use it, without apology, until a better one comes along.